No. 14785

In the United States Court of Appeals for the Ninth Circuit

WEYL-ZUCKERMAN & COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 24-40) are reported at 23 T.C. 841.

JURISDICTION

The petition for review involves a deficiency in corporate income taxes for the taxable year 1947 in the amount of $66,082.54. (R. 41.) A notice of deficiency was mailed to taxpayer on May 22, 1952. (R. 9.) Taxpayer filed a petition for redetermination with the Tax Court on August 18, 1952 (R. 3), under the provisions of Section 272 of the Internal Revenue Code of 1939. The decision of the Tax Court was entered on February 15, 1955. (R. 4, 40-41.) This case is brought to this

Court by a petition for review filed May 11, 1955. (R. 4, 41-44.) The jurisdiction of this Court is invoked under the provisions of Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court was correct in holding that in the computation of a long-term capital gain upon the sale by taxpayer in 1947 of the gas rights (which had no cost basis to it) underlying a tract of land (known as the Henning Tract), the Commissioner properly excluded as cost basis the dividend in kind of those rights supposedly received by it from its wholly owned subsidiary at an asserted fair market value of $230,000, on the ground that the transfer of those rights to the subsidiary in June, 1946, and their re-transfer to taxpayer in December, 1946, were without business purpose, were lacking in *bona fides* and did not result in any stepped-up basis.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.
>
> (a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> * * * * *
>
> (26 U.S.C. 1952 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * *

(26 U.S.C. 1952 ed., Sec. 113.)

STATEMENT

The Commissioner of Internal Revenue determined a deficiency in the income tax of taxpayer, a California corporation, for the year 1947 in the amount of $66,082.54 (R. 9.) That deficiency arose by virtue of the fact that in the determination of long-term capital gain from the sale of mineral and gas rights in 1947, the dividend in kind—mineral and gas rights—supposedly received by taxpayer on or about December 26, 1946,

from its wholly-owned subsidiary, McDonald Island Farms, Ltd., a California corporation, hereinafter referred to as "McDonald Ltd.", at an asserted fair market value of $230,000 was excluded by the Commissioner as a part of the cost basis. (R. 15-18, 33.) The facts, as found by the Tax Court (R. 25-33), giving rise to that deficiency may be summarized as follows:

McDonald Island, located in the Delta Region of the San Joaquin River in San Joaquin County, California, consists of two tracts of land, Henning Tract and McDonald Tract, both used for farming. (R. 25.) The history of the acquisition of those two tracts by taxpayer and the subsequent sale of the gas rights underlying both is as follows:

The Henning Tract was acquired by taxpayer in 1912 at a cost of $338,375. (R. 26.) Its value was written up on taxpayer's books, so that in June 1946, it was carried on the books at a value of $811,750. However, the mineral rights in this tract had no cost basis to taxpayer. (R. 30.) On November 18, 1935, taxpayer leased the mineral rights in the Henning Tract to Standard Oil Company of California, hereinafter referred to as "Standard." (R. 26.) On June 27, 1946, taxpayer conveyed to McDonald Ltd. the entire fee of the Henning Tract, including the surface and mineral rights. This was entered on taxpayer's books as a sale for $338,375 and a book loss of $473,375 was written off to surplus. (R. 30.) The amounts entered on taxpayer's books as the sales price of the Henning Tract ($338,375), and as the sale price for two-thirds of the McDonald Tract surface rights ($226,843.22) hereinafter dealt with, were less than their fair market value on June 27, 1946. On December 21, 1946, McDonald declared a div-

idend in kind of the mineral rights in that tract, and by deed of the same date (recorded January 10, 1947), conveyed those mineral rights to taxpayer. (R. 32.)

For many years prior to 1943, the McDonald Tract was owned by McDonald Ltd. Prior to 1931, neither taxpayer nor any of its shareholders had any interest in that concern. In 1931, three members of the Zuckerman family purchased one-half of the outstanding shares of McDonald Ltd. and Holly Sugar Corporation (hereinafter referred to as "Holly") purchased the remaining one-half interest. Later, in 1934, the Zuckermans transferred their shares to taxpayer. (R. 26.)

On November 18, 1935, McDonald Ltd. leased the mineral rights in the McDonald Tract to Standard. (R. 26.)

On August 11, 1943, McDonald Ltd. declared a dividend in kind, the subject of which was a two-thirds interest in the surface rights of the McDonald Tract. Holly and taxpayer each received a one-third interest. McDonald Ltd. retained the remaining one-third undivided interest in those surface rights and also continued to own the mineral rights in that tract. This dividend was occasioned by the fact that taxpayer and Holly disagreed both as to farming activities on the McDonald Tract and also as to fiscal matters. Taxpayers consented to the dividend on the condition that Holly give it an option to purchase for $120,280.30 the one-third interest to be acquired by Holly as the result of the dividend; Holly executed an option agreement. (R. 26-27).

Taxpayer transferred the option to a partnership comprised of its stockholders and employees, and on December 27, 1944, the partnership exercised the op-

tion and received from Holly its one-third interest in the surface rights of the McDonald Tract. (R. 27.) On or about June 15, 1946, taxpayer purchased from the partnership its one-third interest in those surface rights, paying cash therefor. No deed was ever executed for that transfer. On June 27, 1946, taxpayer sold its two-thirds interest in those surface rights in the McDonald Tract to McDonald Ltd., and so entered the sale on its books. The conveyance with respect to one-third of the surface rights was made directly from the partnership to McDonald Ltd. by deed executed on June 27, 1946. (R. 30.)

With respect to the mineral rights in the McDonald Tract, Holly, in January 1946, and again on March 8, 1946, urged McDonald Ltd. to declare a dividend in kind thereof. Taxpayer, as the owner of 50% of the shares of McDonald Ltd., consented to the declaration of the dividend, on the condition that Holly give it an option to buy its share of the dividend. On March 13, 1946, the dividend was declared and taxpayer and Holly each received a 50% interest in the mineral rights of the McDonald Tract. At the same time, Holly gave taxpayer an option to purchase its 50% interest in the McDonald Tract mineral rights. On the same day Holly also sold to taxpayer its 50% of the capital stock of McDonald Ltd., and taxpayer thereby became owner of all of the outstanding stock of McDonald Ltd. (R. 27-28.)

On June 5, 1946, taxpayer exercised the option to purchase Holly's one-half interest in the mineral rights of the McDonald Tract and thereupon became the owner of all the mineral rights in that tract and had a cost basis for them of $238,666.28. (R. 28.)

In the interim, at a regular meeting of the board of directors of taxpayer on May 1, 1946, a resolution was adopted authorizing its president or vice-president to endorse a promissory note of McDonald Ltd. payable to the Bank of America in the amount of $720,000 and guarantee payment thereof. A promissory note, dated May 20, 1946, was executed by McDonald Ltd. which provided for the payment of $720,000 in installments prior to May 20, 1956. McDonald Ltd. also executed a deed of trust, dated May 20, 1946, "on the property of the corporation commonly known as the Henning Tract and McDonald Tract located on McDonald Island * * *" to secure payment of the note. The deed, which was acknowledged on June 27, 1946, specifically excepted from its provisions "all minerals, mineral substances, mineral interests, ores, oil, gas, asphaltum and other hydrocarbons lying in or under the Henning and McDonald Tracts." (R. 28-29.)

In a letter dated June 15, 1946, to the Bank of America National Trust and Savings Association, McDonald Ltd. applied for a loan of $720,000 "to be evidenced by a promissory note dated May 20, 1946." (R. 29.) This letter stated when payments would be made; that payment of the note was to be secured by deed of trust, and that (R. 29-30):

> The undersigned hereby agrees that on or before the 1st day of April 1947, and annually thereafter, additional payments on account of principal of said loan will be made to said Bank in a sum equivalent to the difference between the minimum payment of Twenty-Eight Thousand Eight Hundred and 00/100 ($28,800.00) Dollars as provided for in said note and 35% of the net profits of the cor-

poration for the prior fiscal year; net profits as here used shall mean profits before depreciation, but after provision for Income Taxes.

The lower left-hand corner of the letter contains the notation in writing "Accepted Julius Blum, Vice Pres. Bank of America N.T. & S.A. Stockton, Calif." (R. 30.)

Henning Tract and McDonald Tract were portions of a single gas field which also included two other properties. As gas was withdrawn from the field, Standard determined the percentage to be allocated to each of the four properties and paid royalties on that basis. Differences developed between taxpayer and Standard in connection with the apportionment of the royalties and the matter of drilling offset wells. There appeared to be two possible solutions: the purchase of the gas rights by Standard or the institution of litigation to resolve the differences. In an effort to solve the problem without litigation, Standard in November of 1945, made an offer to Maurice Zuckerman, president of taxpayer, of $500,000 for gas rights underlying both tracts; the offer was regarded as too low and was rejected. (R. 27, 31.)

In July of 1946, Maurice Zuckerman offered to sell the gas rights in both tracts to Standard for $875,000. Later on the same day, he indicated he would be willing to reduce the figure to $820,000. Standard rejected the offer in August 1946. (R. 31.)

On December 12, 1946, John Zuckerman, then manager of taxpayer and president and manager of McDonald Ltd., told a representative of Standard that they did not like to sue and would like to sell their interests in the gas rights; a basis for determining a

sales price for the mineral rights in both tracts was discussed. (R. 31-32.)

On December 16, 1946, a price for the sale of gas rights underlying both the Henning and McDonald Tracts was agreed upon between representatives of Standard and taxpayer, subject to ratification by their superiors. However, prior to the consummation of the sale, the board of directors of McDonald Ltd., on December 21, 1946, adopted a resolution declaring a dividend in kind of the mineral rights in the Henning Tract. And, as stated above, by deed dated December 21, 1946 (recorded January 10, 1947), McDonald Ltd. conveyed these mineral rights to taxpayer. It was of no importance to Standard whether title to the gas rights underlying the Henning Tract was conveyed directly by McDonald Ltd., or in some other manner, and Standard had prepared papers which were intended to consummate the sale. However, taxpayer's counsel desired that the conveyance take a different route, and the route adopted—involving a transfer of mineral rights underlying the Henning Tract from McDonald Ltd. to taxpayer, followed by a conveyance of gas rights underlying both tracts from taxpayer to the buyer—was in accordance with the plan proposed by taxpayer and the papers subsequently submitted by its counsel. (R. 32.)

Standard elected to take title in the name of a subsidiary, Pacific Oil Company, and, on January 20, 1947, a deed to Pacific Oil Company of gas rights in McDonald Tract and Henning Tract, reserving oil, asphaltum, minerals and hydrocarbons other than gas, and also reserving gas rights below a specified depth, was executed and acknowledged by taxpayer. (R. 32-33.)

On taxpayer's 1946 federal income tax return it reported the receipt of a dividend of the mineral rights underlying Henning Tract at a fair market value of $230,000, and claimed a dividend received credit. (R. 33.)

The gross sales price of the gas rights which taxpayer sold to Pacific Oil Company in January of 1947 was $609,514.46. Of this amount, $230,000 was allocable to the Henning Tract gas rights, and $379,514.46 was allocable to the McDonald Tract gas rights. (R. 33.)

In its income tax return for 1947, taxpayer claimed that its basis for gain or loss on the Henning Tract gas rights was $230,000, that the amount received therefor was $230,000, and reported no profit on their sale. The Commissioner disallowed all of the claimed basis of $230,000 and determined a deficiency of $66,082.54 in taxpayer's income tax for 1947. (R. 33.) In sustaining the Commissioner's determination, the Tax Court concluded as follows (R. 40):

> We are satisfied on the evidence that the course of action taken by petitioner was deliberate and calculated, without business purpose other than to establish an artificially stepped-up basis. The gas rights in the Henning Tract had a zero basis in petitioner's hands, and we hold that the planned excursion of these rights from petitioner to its subsidiary and back again to petitioner could not result in any stepped-up basis. The intermediate steps were lacking in bona fides, and must be ignored.

SUMMARY OF ARGUMENT

The various intermediate steps leading to the sale by taxpayer to Standard of the gas rights underlying

the Henning Tract at an asserted value of $230,000 served no business purpose, were lacking in *bona fides*, and, in fact, were engineered for tax avoidance purposes.

The reasons advanced by taxpayer for the conveyance of the mineral (including gas) rights in that tract to its wholly owned subsidiary, McDonald, in June, 1946, and for the reconveyance thereof to taxpayer in December, 1946, immediately prior to the sale to Standard in January, 1947, are spurious. The alleged farming and financial reasons for the 1946 conveyance pertain only to the surface rights in that tract and the adjacent McDonald Tract, and not to the mineral rights therein. This is clearly demonstrated by the fact that the deed of trust executed to secure payment of the note, providing for repayment of a loan obtained from a bank, to finance the purchase of the fee (surface and mineral rights) in the Henning Tract and two-thirds of the surface rights in the McDonald Tract, specifically excepted from the security all mineral rights in both tracts. Moreover, although taxpayer sold the mineral rights (which had no cost basis to it) in the Henning Tract, it retained the mineral rights in the McDonald Tract which did have a ~~cash~~ cost basis. Again, the sales price to the subsidiary for the Henning Tract, as well as of taxpayer's interest in the McDonald surface rights, was less than their fair market value in June, 1946.

Similarly, the alleged business purpose for the dividend in kind to taxpayer in December, 1946, of the mineral rights in the Henning Tract, namely, to avoid an increase in the amount of the repayment of the loan to the bank which would result if McDonald sold those

rights directly to Standard, is also without merit. In the contingency mentioned, McDonald would have received ample funds with which to meet its obligation.

On the other hand, taxpayer was aware, as early as November, 1945, that Standard was interested in purchasing the gas rights underlying both tracts as one means of settling the controversy which existed with respect to the drilling of offset wells and the payment of royalties under the existing leases of the gas rights in those tracts to Standard. All the intermediate steps taken to secure a stepped-up basis for the gas rights in the Henning Tract, point to the fact that they were pursued only for tax avoidance purposes.

ARGUMENT

The Tax Court Was Correct in Holding That the Transfer of the Mineral Rights in the Henning Tract From Taxpayer to Its Wholly Owned Subsidiary and Back Again to It Was Lacking in *Bona Fides* and Did Not Result in Any Stepped-Up Basis

By June 27, 1946, taxpayer owned the mineral rights in both the Henning and McDonald Tracts. It also owned the surface rights in the Henning Tract and two-thirds of the surface rights in the McDonald Tract —the remaining one-third of the surface rights being owned by McDonald. In addition, taxpayer owned all of McDonald's outstanding stock. By that time (in fact, as early as November, 1945) taxpayer knew that Standard was sufficiently interested in the gas rights in both tracts to have offered a half million dollars for them.

On June 27, 1946, taxpayer transferred to its wholly owned subsidiary, McDonald Ltd. all surface rights in the Henning Tract and two-thirds of the surface rights

in McDonald Tract, thus giving to the subsidiary all surface rights in both tracts. The transfer also included all mineral rights (which had no cost basis to taxpayer) in the Henning Tract. Taxpayer retained all mineral rights in the McDonald Tract. By deed, dated December 21, 1946, McDonald reconveyed to taxpayer all mineral rights in the Henning Tract pursuant to a resolution of the board of directors of the subsidiary declaring a dividend in kind of these mineral rights. Thereafter, by deed dated January 20, 1947, taxpayer conveyed a portion of those rights in both tracts to a wholly owned subsidiary of the Standard Oil Company.

The deed from McDonald to taxpayer purported to effect a distribution of a dividend in kind to taxpayer, Weyl, of all mineral rights in the Henning Tract.[1] Taxpayer reported the receipt of that "dividend" on its 1946 income tax return at a value of $230,000, and claimed a dividend received credit. (Ex. 1 A.)[2] Al-

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[1] A statement attached to Form O (Oil and Gas Depletion Data), accompanying the 1946 return (Ex. 1-A) explains this transaction:

> The other cost in the amount of $230,000.00 represents the fair market value of gas rights received as a dividend from McDonald Island Farms, Ltd. The allocation of the agreed sales price of the gas rights to Standard Oil Company of California in 1947 was considered to be the fair market value at December 21, 1946.

Although taxpayer designated entire record to be printed, the exhibits do not appear in the printed record.

[2] As the Tax Court pointed out (R. 35, fn. 1), on taxpayer's theory, the re-transfer of these rights to it by the subsidiary would result in taxpayer receiving a taxable dividend in the amount of $230,000. However, under the provisions of Section 26(b) of the 1939 Code, 85% of that dividend is received tax free. In substance, therefore, the tax advantage to taxpayer would be that it would be chargeable with the dividend income in the amount of only 15% of $230,000, while the entire gain of $230,000 upon the sale of the gas rights to Standard would be tax free.

though those gas rights had a zero basis in its hands for a number of years, it is taxpayer's contention that by reason of the conveyance to the subsidiary and reconveyance some six months later as a "dividend," these rights acquired a stepped-up basis equal to $230,000, with the result that it realized no gain upon the consummation of the sale of a portion thereof to Standard in 1947.[3] It is the position of the Commissioner, in which the Tax Court concurred that the transfer of the mineral rights to the subsidiary was not *bona fide;* that no business purpose was served or intended by such transfer; that the possible sale to Standard Oil was contemplated from the beginning; and that the round-trip of those rights from parent to subsidiary and back to parent again was engineered for the purpose of attempting to obtain a stepped-up basis. Accordingly, in determining the long-term capital gain from the sale of mineral rights in 1947, the Commissioner and the Tax Court refused to consider the asserted fair market value of $230,000 for the mineral right in the Henning Tract as a part of the cost basis. (R. 18.)

Whether or not the Commissioner was justified in his

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[3] Taxpayer's 1946 and 1947 returns (Exs. 1-A and 2-B) make it appear that the Henning mineral rights received as a dividend and those sold to Standard were identical and had a $230,000 value. It is clear from Petitioner's Exhibit 9 and Respondent's Exhibit G, however, that taxpayer retained substantial mineral rights in the Henning Tract, conveying only the gas rights which the Tax Court found (R. 34) had a value at the time of sale of $230,000. Of course, no adjustment to 1946 income was made in the deficiency notice (R. 15-16) to reflect the value of these retained rights, since under the Commissioner's view of the entire transaction there was no 1946 income from receipt of the mineral rights, but, under taxpayer's view the value of the retained rights should have been included in the value of the dividends received by it.

action depends upon whether the dividend in kind declared by the subsidiary in December 1946, was a *bona fide* dividend. That, in turn, depends upon whether the transfer of the mineral rights to the subsidiary was made with a *bona fide* business purpose or whether it so lacked business purpose that it should be disregarded. The question is essentially one of fact and in determining the incidence of taxation with respect to the transaction it is necessary to look through the form and ascertain its substance. *Commissioner* v. *Court Holding Co.,* 328 U.S. 331; *Griffiths* v. *Commissioner,* 308 U.S. 355; *Higgins* v. *Smith,* 308 U.S. 473; *Gregory* v. *Helvering,* 293 U.S. 465. That being so, the findings and conclusions of the Tax Court herein sustaining the Commissioner's determination should not be disturbed unless "clearly erroneous," due regard being had for the opportunity of the trial court to judge the credibility of witnesses. *United States* v. *Gypsum Co.,* 333 U.S. 364, 394-395, rehearing denied, 333 U.S. 869; *Gillette's Estate* v. *Commissioner,* 182 F. 2d 1010, 1014 (C.A. 9th); *Grace Bros.* v. *Commissioner,* 173 F. 2d 170, 173 (C.A. 9th); Rule 52(a), Federal Rules of Civil Procedure.

At the outset, we note that, as below, taxpayer misconceives the nature of the case and the onus of the burden of proof, for it speaks of having been "convicted" of a "tax fraud" (Br. 29-30, 45), and of the Commissioner's having the "affirmative" of establishing its intent to recapture the mineral rights from McDonald so as to evade taxes, inasmuch as taxpayer had allegedly introduced evidence attempting to rebut the presumption of the correctness of the Commissioner's determination (Br. 39-45). This case, of course,

relates to civil, not criminal, tax liability, and does not involve the issue of fraud and the imposition of any fraud penalties; hence the provisions of Section 1112 of the 1939 Code, cited by taxpayer (Br. 45), are not pertinent. This case involves simply an understatement of taxable income, and as the Tax Court observed (R. 36), the burden is not upon the Commissioner, but rather upon the taxpayer to overcome the correctness of the Commissioner's determination. *Welch* v. *Helvering,* 290 U.S. 111, 115; *San Joaquin Brick Co.* v. *Commissioner,* 130 F. 2d 220, 225 (C.A. 9th); *Buck* v. *Commissioner,* 83 F. 2d 786, 788 (C.A. 9th).

In an attempt to establish a business purpose for the transfer of the mineral rights in the Henning Tract and their recapture from the McDonald prior to their sale to Standard, taxpayer relies principally upon certain so-called "farming" and "financial" reasons. (Br. 12-13; R. 55.) These reasons were succinctly set forth in a written protest (Resp. Ex. E; R. 36-37) filed by taxpayer against the proposed deficiency which stated in material part (p. 3) that—

> The transfer was made so that all the McDonald Island property would be owned by one company and thereby lend itself to a more efficient conduct of farming operations. Also, all the land could then be pledged as collateral to a trust deed note with a bank. * * *

Those reasons were repeated and embellished in the testimony before the Tax Court (R. 38, 49-50, 54-58), and are also relied upon by taxpayer on brief herein (pp. 12-13). The Tax Court concluded (R. 37) that both reasons were "spurious" in that they related to

surface rights rather than the *mineral* rights in question.

Thus it pointed out (R. 37) that, while it may have been true that farming operations on McDonald Island could have been more efficiently conducted if all surface rights were in a single ownership, the ownership of the mineral rights was completely irrelevant in that respect. Further evidence of this point is found in the fact that when, on June 27, 1946, taxpayer transferred to McDonald, its subsidiary, the Henning Tract (Pet. Ex. 10), and its two-thirds interest in the surface rights in the McDonald Tract, it retained and did not transfer to the subsidiary the mineral rights in the McDonald Tract (Pet. Exs. 6 and 7). Again, when at a meeting of the Board of Directors of McDonald on December 21, 1946, it declared a dividend of the mineral rights underlying the Henning Tract to taxpayer, its parent company, the resolution adopted expressly recited that "none of the rights * * * are necessary for the operation of the business of this corporation and may be distributed to the stockholder thereof by way of a dividend in kind." (Pet. Ex. 8.) As the Tax Court commented (R. 37), it is quite plain that these mineral rights were no more necessary to the business of the subsidiary on June 27, 1946, when they were first transferred by taxpayer as part of the entire Henning Tract. Moreover, since, as taxpayer admits (Br. 5), both tracts "had been farmed extensively year after year under separate ownership", the alleged farming and operating reasons pale into insignificance for that reason also.

Taxpayer also attempts to explain this re-transfer of the Henning Tract mineral rights as having been "dic-

tated by business necessity." (Br. 37.) The allusion is to the alleged "financial" reasons,[4] mentioned in the protest, pertaining to the pledge of the land as collateral for a bank loan. Taxpayer argues (Br. 16), that the Henning Tract was transferred to McDonald as part of a business transaction which was essential to provide the funds "for buying out Holly's share".[5] With respect to this loan and the security therefor, the Tax Court found (R. 28-29) that, pursuant to authority of taxpayer's board of directors granted on May 1, 1946 (at which time taxpayer owned all the outstanding stock of McDonald), a promissory note, dated May 20, 1946, was executed by McDonald. The note provided

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[4] Taxpayer also attempts to supply a business reason for the transfer of the Henning Tract by listing (Br. 14) certain alleged business advantages of selecting McDonald as the borrower, namely, an advantageous excess profits base, a right to a substantial potato acreage in the Government's price support program, and a good credit rating. These reasons, even if valid with respect to obtaining the loan, nevertheless only relate to the surface rights, since, as developed below, the mineral rights were excluded from the loan security.

[5] The price paid for that stock, on the occasion of its acquisition on March 13, 1946, was $216,620, and taxpayer apparently borrowed that sum from the Bank of America. (R. 48.) Almost immediately thereafter, John Zuckerman began negotiating further with the bank for a loan of $720,000 in order to purchase from taxpayer the Henning Tract (surface rights—$338,375), two-thirds of the surface rights in the McDonald Tract ($240,000), and to provide for the acquisition of Holly's 50% share of the McDonald Tract mineral rights. Taxpayer used the payments received by it from McDonald to repay the bank the sum of $216,620 borrowed to purchase Holly's share of the McDonald stock, and also to pay for the mineral rights acquired from Holly. (R. 48-49, 57-58, 137-138.) Thus, even though McDonald was the "borrower", it appears that the principal reason for and net result of the loan was to give taxpayer effective control over the mineral rights in both tracts.

for the payment of $720,000 in installments prior to May 20, 1956. At the same time, McDonald also executed a deed of trust "on the property of the corporation commonly known as the Henning Tract and McDonald Tract located on McDonald Island * * *" to secure payment of the note. The deed, which was acknowledged on June 27, 1946 (the date of the transfers by taxpayer to McDonald), specifically excepted from its provisions "All minerals, mineral substances, mineral interests, ores, oil, gas, asphaltum and other hydrocarbons lying in or under the Henning and McDonald Tracts." (R. 29.) Rejecting taxpayer's argument that the circumstances pertaining to this loan constituted a business reason for the transfer of the mineral rights by taxpayer, the Tax Court stated (R. 37-38), that the evidence showed that the loan in question had already been negotiated, and that it was to be secured by a deed of trust with respect to the entire island, excluding, however, all mineral rights. Consequently, as the Tax Court in effect concluded (R. 38), the proposed bank loan was not a motivating factor in the transfer of the *mineral* rights to the subsidiary. It related only to the *surface* rights in the two tracts. Contrary to taxpayer's contention (Br. 8, 22, 23-24), the fact that the deed (Pet. Ex. 10) conveying the Henning Tract may have been in the usual and customary form does not serve to establish a business purpose for the transfer, for on the very same day, June 27, 1946, the deed (Pet. Ex. 7) of its interest in the McDonald Tract to the same subsidiary expressly excluded the mineral rights, and, as pointed out above, the deed of trust (Pet. Ex. 3) securing the bank loan expressly excluded the mineral rights under the very (Henning) tract involved herein.

Pursuing this "financial" reason, taxpayer argues further (Br. 3, 9, 11, 31) that rather than showing a preconceived plan to declare a dividend in kind of the mineral rights in the Henning Tract, as a preliminary step in the sale to Standard, the evidence merely shows that when the time for the conveyance arrived, McDonald was confronted with the prospect of making a payment of $50,000 on the principal of the bank loan[6] in the event that it should transfer those rights directly to the buyer (Standard), and that the $50,000 could not be spared. In other words, taxpayer seeks to have accepted as a business reason for the reconveyance to it of the Henning Tract mineral rights, prior to their conveyance to Standard, an alleged desire to switch the profit from their sale from McDonald so that the latter could evade its contractual obligation to the Bank of America. Even if successful, McDonald could not profit in the long run by such a maneuver for it was obligated to repay the full $720,000 loan. And, in any event, the argument is specious for had McDonald made the sale directly, it would have received the $230,000 and thus would have had ample funds with which to honestly meet its obligations.

Further evidence that this particular reason was not *bona fide* but merely imaginary, is found in the fact that in 1950 taxpayer was contending that the reconveyance to it was made because of the insistence of the buyer, Standard's nominee, Pacific Oil Company. This is apparent from the protest against the proposed

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[6] Under the terms of the bank loan (Pet. Ex. 4), McDonald agreed to make payments on the principal of the loan equal to 35% of the corporation's net profits after taxes less $28,800.00. (See also R. 95-96.)

deficiency (Resp. Ex. E) wherein taxpayer states (p. 3-4):

> The third party, Pacific Oil Company, was interested only in the purchase of all the known mineral rights on the island as a whole * * *.
>
> McDonald Island Farms, Ltd. therefore declared as a dividend all the known mineral rights it owned so that the sale could be consummated by the parent company.[7]

Moreover, it was admitted that the mineral rights could have been transferred to Standard by two deeds rather than one, and George Schroeder, who negotiated the transaction for Standard testified (R. 171), and the Tax Court found (R. 32), that it was of no consequence to the latter what route the conveyances took, whether directly by McDonald, or in some other manner, as long as Standard was the ultimate grantee. As far as the purchaser was concerned, therefore, there was no necessity for the reconveyance of the mineral rights by McDonald to taxpayer.[8]

As an additional reason, supporting a business purpose, taxpayer argues (Br. 9-10, 14) that by reason of the controversy with Standard as to its obligation with respect to drilling offset wells "it was advisable to keep separate the ownership of the mineral rights in the

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[7] See also to same effect a statement of a representative of taxpayer at a conference held in the San Francisco office of the Internal Revenue Agent in charge on March 17, 1950 (R. 188-189, 192), and testimony of John Zuckerman (R. 94) in answer to the reasons for the declaration of the dividend of the Henning Tract mineral rights in December, 1946.

[8] There is some indication that Standard had prepared papers to effect separate conveyances from taxpayer and McDonald. (R. 32, 170-174.)

two tracts," since if all mineral rights in the entire island were under single ownership, it might have the effect of relieving Standard of the obligation of drilling offset wells. This argument is predicated on the vague testimony of a witness, John Zuckerman (R. 66-67, 86-87), which falls short of establishing that it actually constituted a reason, in the minds of taxpayer's officers, for separating ownership of the mineral rights in the two tracts. In any event, the argument is without merit since it fails to explain just how offset wells would be economically advantageous between tracts which are owned by one economic interest, namely, taxpayer and its wholly owned subsidiary, McDonald. Where adjacent gas tracts are owned by different economic interests, it is understandable that offset wells may be employed to prevent one owner from taking more than its share, but such is not the situation here.

From the foregoing, it is clear that taxpayer has advanced no sound business reason to account for the conveyance of the mineral rights in June, 1946, and their reconveyance in the form of a dividend in December, 1946, immediately prior to the consummation of the sale to Standard.

It is the position of the Commissioner, in which the Tax Court concurred, that viewing the overall transaction, the ultimate sale of the gas rights must have been anticipaed by taxpayer's president, Maurice Zuckerman, prior to June 27, 1946, and that no sound business purpose existed for the transfer and re-transfer of the Henning Tract mineral rights other than to reduce income taxes on the ultimate sale.

It must be remembered, as the Tax Court pointed out (R. 27, 38), that taxpayer was experiencing difficulty

with Standard in connection with the latter's leases of the gas rights, and that one way of settling the dispute was to have Standard purchase the rights. Toward that end, Standard made an offer of $500,000 for the gas rights under the entire island in November, 1945. Although the offer was rejected as being too low, at least it served to inform taxpayer's president, Maurice Zuckerman, that Standard was willing to resolve the difficulties by purchase of the gas rights. At that time, although taxpayer owned the entire fee in the Henning Tract, it owned only one-third of the surface rights in the McDonald Tract, and, by virtue of its ownership of 50% of the stock of McDonald, it had a one-half interest in the mineral rights underlying the McDonald Tract. By June 26, 1946, however, a series of transactions had taken place as a result of which it not only retained entire ownership of the Henning Tract, but also owned all the mineral rights in the McDonald Tract, two-thirds of the surface rights in that tract (the other one-third being owned by McDonald), and all the McDonald stock. It thus had complete control over both tracts and was in a position to control and handle the possible settlement of the difficulties with Standard by sale on its own terms. See *Bank of America National Trust & Savings Assn.* v. *Commissioner,* 15 T.C. 544, 555, affirmed *per curiam,* 193 F. 2d 178 (C.A. 9th). That it envisaged such a sale and the tax consequences thereof by June 26, 1946, when it conveyed the entire fee in the Henning Tract to McDonald, is evidenced by several factors. First, although that tract had cost taxpayer $338,375, when it first acquired it in 1912, it had a book value of $811,750 in June, 1946. (The mineral rights had no cost basis to taxpayer since the presence of gas was not

indicated until 1935 or brought into production until 1937.) Nevertheless, when it conveyed the entire fee of the Henning Tract, including both the surface and mineral rights, to McDonald on June 27, 1946, it entered the transaction on its books as a sale for $338,375, and a book loss of $473,375 was written off to surplus. However, the amounts entered on its books as the sale price ($338,375), as well as the sale price for two-thirds of the McDonald Tract surface rights ($226,843.22), were less than their fair market value on June 27, 1946 (R. 26, 30-31, 34.) Regardless of what proper accounting and bookkeeping procedure might require in the case of a sale of an asset by a parent to its subsidiary at more than cost (Br. 33-36), that certainly did not prevent a sale of the Henning Tract mineral rights at their market value.

Secondly, although taxpayer conveyed the mineral rights in the Henning Tract which had no cost basis to it, to McDonald, it retained the mineral rights in McDonald Tract which had a cost basis to it of $238,666.28. (R. 28.) That the transfer of the former rights was a conscious act rather than an incidental by-product of the conveyance of the surface rights, is conclusively shown by the deed of trust, dated May 20, 1946, and acknowledged June 27, 1946, in which the surface rights in both tracts were conveyed to the trustee, but with the mineral rights specifically excluded. Moreover, although taxpayer had in form sold the mineral rights in the Henning Tract, it had done so in such a way that title was in a wholly owned subsidiary from which it could reacquire title at any time it might decide to sell those rights, and the deed of trust had been drafted so as not to interpose any obstacle to such a sale. Obviously

since taxpayer had a cost basis for the McDonald Tract mineral rights, it had no "tax evasion" reason (Br. 25) for conveying them to McDonald at the time it conveyed the Henning mineral rights.

Thirdly, further evidence that taxpayers' officers contemplated the ultimate sale of the Henning Tract mineral rights to Standard at the time of their conveyance to McDonald in June, 1946, exists in the fact, also pointed out by the Tax Court (R. 38-39), that promptly thereafter, in July, 1946, taxpayer's president Maurice Zuckerman went to the offices of Standard and offered to sell the gas rights underlying both tracts for some $800,000 (R. 152). Schroeder, Standard's representative testified (R. 153) that there were further discussions in August, 1946, apparently about a possible law suit, the effect of which probably also facilitated the ultimate sale (R. 153-157).

Finally, when the sale to Standard was arranged, taxpayer reacquired title to the Henning mineral rights prior to making the conveyance to the buyer, although, as pointed out above, the alleged dividend served no business purpose; the conveyance of the rights could have been made by deed from McDonald, and it was of no consequence to Standard what route the conveyances took.[9] Under the circumstances, the "dividend" can only be considered as a distribution to escape a tax. *Commissioner* v. *Transport Trad. & Term. Corp.*, 176 F. 2d 570, 572 (C.A. 2d), affirmed *per curiam*, 338 U.S.

[9] The fact that the "dividend" was disregarded for purposes of determining taxpayer's gain on the ultimate sale, does not mean that the sale of those rights must be deemed to have been made by McDonald so as to subject it to a tax thereon, as taxpayer argues. (Br. 4-5, 37-38.) The fact is that the original conveyance was part of the sham and is also disregarded, so that the ultimate conveyance to Standard was made by taxpayer.

955, rehearing denied, 339 U.S. 916. At the time of their reacquisition, a portion of those rights had a fair market value of $230,000 constituting that portion of the gross sales price of the gas rights sold to the ultimate buyer, Pacific Oil Company, in January, 1947, allocable to the Henning Tract gas rights.

As a consequence of this tax avoidance scheme, taxpayer understated its 1947 income from the sale of the Henning Tract gas rights in the amount of $230,000 with a resultant tax deficiency of some $66,000. (R. 18-19.) That the Commissioner correctly determined this deficiency by disregarding the "dividend" as a sham is readily apparent from viewing the transaction as a whole. The *bona fides* or substance of the dividend in kind in December 1946, is not an isolated factor; its substance depends upon the substance of the subsidiary's ownership of the mineral rights and that in turn is related to the substance of the conveyance of the mineral rights in June, 1946. The latter, in turn, depends upon whether there was a *bona fide* business reason for the conveyance. As the Supreme Court said in *Commissioner* v. *Court Holding Co., supra,* p. 334:

> The incidence of taxataion depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant.

We submit, that on the evidence as a whole the possible sale to Standard was contemplated from the begin-

ning, and that the Tax Court correctly concluded (R. 40) that the intermediate steps were lacking in *bona fides* and had to be ignored.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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